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By L. L. Briggs

Shares of corporation stock are often held by an estate under a will in which the testator provides that the income of the estate is to go to a party called a life-tenant as long as that person lives and at his death the principal passes to another party known as a remainderman. Whether the former or the latter is entitled to stock dividends on such stock is an extremely difficult question to decide and it is one which has caused the courts of the United States and of England much trouble for more than a century. There is considerable variation in the decisions of the courts of the several states, and to make the subject more perplexing, there are inconsistent rulings within the same jurisdiction. This conflict of authority is probably due in part to the unusual amount of litigation between tenants for life and remaindermen in respect to this kind of dividend and in part to the fact that the business corporation is such a comparatively recent development in our economic structure that there has been a lack of precedents in the common law to guide the jurists in making their decisions. However, four fairly well-defined rules have been developed by the courts, namely: the American or Pennsylvania, the Massachusetts, the Kentucky and the English rule.

Under the American or Pennsylvania rule, the time with relation to the life term in which the profits being capitalized by the stock dividend were earned determines whether the life-tenant or the remainderman is entitled to the distribution. The courts may inquire as to the time and method of accumulation of such profits (*Soehnlein* v. *Soehnlein* (1911) 146 Wis. 330). They may look into the facts, circumstances and nature of the transaction and determine the nature of the dividend and the rights of the contending parties according to justice and equity (*Matter of Osborne* (1913) 209 N. Y. 450). If the entire fund was accumulated before the beginning of the life estate, the stock dividend goes to the remainderman (*Smith's Estate* (1891) 140 Pa. 344); while if the profits capitalized by the declaration of the dividend were earned subsequent to the inception of the life estate, the distribution belongs to the life-tenant (*Lord* v. *Brooks* (1872) 52

N. H. 72). According to Justice Marshall in *Soehnlein* v. *Soehnlein* (1911) 146 Wis. 330:

> "In disposing of stock or property dividend as between tenant and remainderman the court may properly inquire as to the time when the fund out of which the extraordinary dividend is to be paid was earned or accumulated, and also as to the method of accumulation. If it is found to have accrued or been earned before the estate arose it may be held to be principal; and, without reference to the time when it is declared or made payable, to belong to the corpus of the estate and not go to the life-tenant. But when it is found that the fund, out of which the dividend is paid, accrued or was earned, not before, but after the life estate arose, then it may be held that the dividend is income and belongs to the life-tenant."

The justice who gave the decision in *Matter of Heaton* (1915) 89 Vt. 550, stated the rule in the following words:

> "By the rule we adopt, the life-tenant receives all the profits of the corporation accumulated during the life of the trust which are released from corporate control and distributed among the stockholders during the life tenancy, regardless of the form of the distribution; and the remainderman receives at the end of the term the corpus of the trust fund undiminished in value from what it was at the inception of the trust, which is all that he can justly claim, unless the creator of the trust has evidenced an intention that he shall receive more. It works out exact justice between the parties and, we believe, will more often give effect to the unexpressed intention of the testator."

In case the earnings were accumulated partly before and partly after the beginning of the life estate, the stock dividend must be divided between the tenant for life and the remainderman, the former taking the stock representing the portion of profits earned after the creation of the trust fund and the latter the part which was earned before that date. Justice Chase, in *Matter of Osborne* (1913) 209 N. Y. 450, said:

> "Extraordinary dividends, payable from the accumulated earnings of the company, whether payable in cash or stock, belong to the life beneficiary, unless they intrench in whole or in part upon the capital of the trust fund as received from the testator or maker of the trust or invested in the stock; in such case such extraordinary dividends should be returned to the trust fund or apportioned between the trust fund and the

> life beneficiary in such a way as to preserve the integrity of the trust fund."

Justice Chase, in the same case, gave the following definite directions for the apportionment of the dividend between the parties:

> "The intrinsic value of the trust investment is to be ascertained by dividing the capital and the surplus of the corporation existing at the time of the creation of the trust by the number of shares of the corporation then outstanding, which gives the value of each share, and that amount must be multiplied by the number of shares held in the trust. The value of the investment represented by the original shares after the dividend has been made is ascertained by exactly the same method. The difference between the two shows the impairment of the corpus of the trust. . . . If the dividend is in stock the amount of impairment in money must be divided by the intrinsic value of a share of the new stock and the quotient gives the number of shares to be retained to make the impairment good—the remaining shares going to the life beneficiary."

The presumption is that every stock dividend is from earnings since the creation of the life estate and consequently goes to the life-tenant (*Matter of Leask* (1913) 159 N. Y. App. Div. 102). According to Justice Potter in *Matter of Robinson* (1907) 218 Pa. St. 481:

> "We may conclude therefore on principle that presumptively every dividend . . . in new shares, goes to him who was the beneficial holder of the shares at the time when it was declared. This will carry every dividend presumptively to the life-tenant instead of to the remainderman."

The remainderman is entitled to what the stock was actually worth when the trust was created (*Appeal of Boyer* (1909) 224 Pa. St. 144). In *Gilkey* v. *Paine* (1888) 80 Me. 319, the court said:

> "The effort in this country has been generally to maintain the integrity of the capital and to give all surplus earnings, in whatever form distributed, to the life-tenant. And, perhaps, no better rule than this can be adopted."

However, the burden of proof is upon the remainderman to show that the principal has been impaired by the stock dividend (*Kalback* v. *Clark* (1907) 133 Iowa 215). If he is unable to prove this to the satisfaction of the court he will not be entitled to any of the dividend.

Where there is no accumulation of earnings and a stock dividend is declared from surplus representing appreciation of the assets of the corporation, the remainderman is entitled to the distribution. Such distribution in these circumstances is justified by the court, in *Kalback* v. *Clark* (1907) 133 Iowa 215, in the following words:

> "If, however, the so-called stock dividends represent the corporate capital—that is, represent nothing but the natural growth or increase in the value of the permanent property, so that there is merely a change in the form of ownership—such stock should go to the remainderman; for in such case the dividend is a dividend of capital, representing simply an increase in the value of the physical property, goodwill or other things of tangible value."

The decision of *Kalback* v. *Clark* was followed by the court in *Poole* v. *Union Trust Company* (1916) 191 Mich. 162, and has been followed by the courts of several other states. In *Holbrook* v. *Holbrook* (1907) 74 N. H. 201, it was held to make no difference whether the increase in value of the assets occurred before or after the creation of the trust.

There is some conflict of authority among the states following the American rule as to whether the court need accept the statement of the board of directors as to the source of dividends when the apportionment of them between life-tenant and remainderman is the problem for solution. In *Matter of Northern Central Railway Dividend Cases* (1915) 126 Md. 16, the court held that the declaration of the corporation that the dividend represents profits must be followed by the court in deciding whether a stock dividend is corpus or income. A few years later, a California court (*Matter of Duffil's Estate* (1919) 180 Cal. 748) decided that the determination of the directors of a corporation as to the sources of its dividends has no binding or persuasive effect upon the court when it is required to decide whether a stock dividend is corpus or income in order to determine its ownership as between tenant for life and remainderman.

The Massachusetts courts have adopted the rule that the intent of the corporation as shown by its votes in declaring the dividend determines whether such distribution is an apportionment of additional stock or a division of profits among the stockholders (*Rand* v. *Hubbell* (1874) 115 Mass. 461). The declaration of a stock dividend shows the intention of the corporation to retain its profits as capital: consequently, the remainderman is entitled to the shares distributed. According to Chief Justice Chapman in the leading case of *Minot* v. *Paine* (1868) 99 Mass. 101:

> "The money in the hands of the directors may be income to the corporation; but it is not so to a stockholder until a dividend is made; and, where the company invests it in buildings and machinery, or in railroad tracks, depots, rolling stock, or any other permanent improvements, for enlarging or carrying on their legitimate business, it never becomes income to the shareholder. The investment becomes an accretion to capital; and it is equally so whether they increase the number of shares, or the par value of the shares, or leave the shares unaltered."

The rights of the life-tenant and the remainderman are determined by what part of the property is held in the business as a fund to be used to advance the interests of the company and what part is permanently separated from the business and turned over to the stockholders (*D'Ooge* v. *Leeds* (1900) 176 Mass. 558). The court, in *Lyman* v. *Pratt* (1903) 183 Mass. 58, said:

> "The real question is whether the distribution made by the corporation is of money to be taken and used as income, or of capital to be retained in some form as an investment in the corporation."

In brief, all stock dividends, whenever earned and however declared, are considered to be capital and as such they pass to the remainderman. According to the court in *Leland* v. *Hayden* (1869) 102 Mass. 542:

> "We must regard the principle as settled, that stock dividends are to be regarded as principal . . ."

Chief Justice Chapman, in *Minot* v. *Paine* (1868) 99 Mass. 101, said:

> "A simple rule is to regard . . . stock dividends, however large, as capital."

The court, in *Coolidge* v. *Grant* (1925) 251 Mass. 352, made the following statement:

> "Cash dividends, however large, are regarded as income, and stock dividends, however made, as capital."

Seeing the unfairness of this rule, but feeling compelled by the doctrine of stare decisis to follow it, several Massachusetts courts have taken pains to justify their actions. In *Rand* v. *Hubbell* (1874) 115 Mass. 461, the court maintained that:

> "It would be impracticable for the courts, in determining the comparative rights of different persons in a particular share of stock, to go behind the votes of the corporation and its directors, and investigate the accounts and affairs of the corporation, in order to ascertain how the corporation acquired the funds out of which the dividend was declared."

Another defense of the rule was given in *Smith* v. *Dana* (1905) 77 Conn. 543:

> "It was not pretended that this rule, which has been commonly known as the Massachusetts rule, was the ideal rule of reason; nor have the courts of high authority which have given their approval of it ever claimed it to be such, or one which would accomplish exact justice under all circumstances. What has been claimed for it is that its general application, at least if due regard be had for the substance and intention of the transaction, would prove more beneficial in its consequences, and on the whole tend to results more closely approximating to what was just and equitable than would the application of any other rule or any attempt to go behind the declaration of the dividend to search out and discover the equities of each case according to some theoretical ideal."

Realizing the injustice that would result from a strict adherence to the rule, several Massachusetts courts have dared to ignore the force of precedent and have declined to follow it in certain hard cases. In *Heard* v. *Eldredge* (1872) 109 Mass. 258, the court said:

> "The suggestion that the intention of the directors should determine the question whether the dividend is capital or income can not be correct. . . . It is more safe to look at the character of the property and the transaction."

The courts in *Gray* v. *Hemenway* (1912) 212 Mass. 239 and *Smith* v. *Cotting* (1918) 231 Mass. 42 did not follow the Massachusetts rule.

The Massachusetts rule has the advantage of simplicity and convenience in application. The corporation, by declaring the dividend in the form of stock, decides for the trustee of the estate that the distribution is from capital and consequently goes to the remainderman. The trustee is relieved of the task of applying to the court for instructions as to the method of handling it.

However, in many cases, this arbitrary rule is certain to work great injustice. The corporation may, in the absence of restraining statute, treat all its undivided earnings as capital by issuing stock dividends to represent the increase in surplus. Since, by this rule, the remainderman is entitled to stock dividends, the tenant for life would receive nothing, with the result that the intention of the testator would, in many instances, be defeated. This doctrine confuses capital of the estate with capital of the corporation and when it permits the board of directors of a corporation to decide the ownership of dividends as between life-tenant and remainderman it takes away from the courts the power of dispensing justice after a view and consideration of the facts of the case.

The Kentucky rule in regard to stock dividends declared out of earnings is that they are income and go to the tenant for life regardless of whether such capitalized profits were accumulated before or after the beginning of the trust estate in the stock upon which the distribution is made (*Cox* v. *Gaulbert* (1912) 148 Ky. 407). In *Hite* v. *Hite* (1892) 93 Ky. 257, the court said:

> "It is the rule as settled by the current of authority that dividends . . . of stock . . . are non-apportionable, and must be considered as accruing in their entirety as of the date when they are declared . . . No inquiry will in such case be made as to what portion of the profit upon which the dividend was based was earned before or after the death of the testator for the purpose of apportioning between the tenant for life and the remainderman. The difficulty attending such an inquiry, the impossibility of attaining accuracy, and of ascertaining the many sources from which the profit has been derived, are the reasons for the rule."

According to the early English rule, all ordinary stock dividends became the property of the life-tenant and all extraordinary distributions of stock went to the trust fund to be turned over to the remainderman at the death of the life beneficiary (*Brander* v. *Brander* (1799, Ch.) 4 Ves. Jr. 800). There is no evidence of investigation on the part of the courts to determine whether the profits upon which these dividends were based were earned before or after the life-tenancy began. The reasons for the adoption of such an arbitrary doctrine seem to have been the practical ease of application and the inconvenience of examining the corporation's records. It has been said that at least one English decision implies that its confirmation may have been due to pressure brought by the Bank of England when the court intimated its intention to examine the books of that institution in order to obtain information needed for the purpose of apportioning dividends between rival claimants (*Irving* v. *Houston* (1803, house of lords) 4 Paton 521). The rule was obviously unfair to the life-tenant, and while it was recognized in England as late as 1856, there were many departures from it even among the earlier cases and at the present time it is practically obsolete in that country.

The modern English doctrine is very similar to the Massachusetts rule. The rights of the life-tenant and the remainderman to a dividend are based on the arbitrary distinction between cash and stock dividends, the former going to the tenant for life if declared after the creation of the trust although they were earned before that time (*Bates* v. *Mackinley* (1862) 31 Beav. 280) while the latter become the property of the remainderman, except in cases of companies that cannot legally increase their capital stock (*Bouch* v. *Sproule* (1887, house of lords) 12 App. Cas. 385).

The English jurists maintain that profits of the corporation are not necessarily earnings or income of the trust. The directors have control of the corporation's affairs and they may treat the profits as suitable for distribution in cash or for the increase of capital and their decision is final. Consequently, the corporation, by the form in which it declares the dividend, determines the ownership as between the tenant for life and the remainderman. Vice-chancellor Sir W. Page-Wood, in *Re Barton's Estate* (1868) L. R. 5 Eq. 238, said:

> "As long as the company have the profit of the half year in their hands, it is for them to say what they will do with it, subject, of course, to the rules and regulations of the company. . . . The dividend to which a tenant for life is entitled is the dividend which the company chooses to declare. . . . Where the company, by a majority of their votes, have said that they will not divide its money, but turn it all into capital, capital it must be from that time."

The American or Pennsylvania rule seems to be most popular in our country. It is followed by the courts of California, Delaware, Iowa, Maryland, Michigan, Minnesota, New Hampshire, New Jersey, New York, Pennsylvania, South Carolina, Tennessee, Vermont, Wisconsin, and Hawaii. The Massachusetts rule is supported by a decision of the United States supreme court

(*Gibbons* v. *Mahon* (1890) 136 U. S. 549); it has been enacted by statute in Georgia, and is followed by the courts of Connecticut, Illinois, Maine, North Carolina, Ohio, Rhode Island, West Virginia and Wyoming. At the present time, Kentucky is alone in following the rule which bears its name, although up to 1913 it was favored by the courts of New York. As far as the writer has been able to ascertain, the question of ownership of stock dividends as between life-tenant and remainderman has not come before the supreme courts of the states which have not been mentioned.